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C O N F I D E N T I A L SECTION 01 OF 03 TEL AVIV 003188

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TAGS: [ECON PREL IS ECONOMY AND FINANCE](#)

SUBJECT: ISRAEL: MODERATING FIRST QUARTER GROWTH POSES

SMALL RISK TO ANOTHER GOOD YEAR

Classified By: Economic Counselor William Weinstein for Reasons 1.4 (b, d)

1. (U) Israeli growth moderated in the first quarter of 2005 to 2.9%, following four quarters of growth in 2004 between 3.5 to 4.4%. Business sector GDP grew by 3.4%, which was also lower than any quarter in 2004. The overall deceleration reflected moderating growth of both exports and imports during the quarter. The slowdown did not come as a surprise. The Bank of Israel (BOI) writes in its May Economic Developments report that "signs of a slower pace of expansion in the economy were apparent before the beginning of 2005." This was reflected in moderating growth since the second quarter of 2004 in both the BOI's S-index (composite state of the economy index); and in the exports of goods and services, excluding high tech companies and diamonds. The key question on economists' minds, which will require more than one quarter of data, is whether the growth slowdown is temporary or represents a fundamental change in the growth trend.

2. (SBU) Israelis with whom we have spoken are unconcerned about any significant, long-term slowdown, ascribing the numbers either to technical factors or to a change in the makeup of growth. Finance Ministry Director General Bachar ascribed at least part of the moderation in a May 19 radio interview to uncertainty relating to disengagement, as well as to the last minute approval of the 2006 budget. Finance Ministry staff continue to forecast 2005 growth at 3.8%. Bank Leumi's Gil Bufman refers to the quarter as a "speed bump" that hides a more fundamental shift in the economy from export-led to domestic-led growth. He stands by an estimate of 4% growth for the year, only slightly lower than his previous forecasts.

Trade: Moderating Growth

3. (U) The Central Bureau of Statistics (CBS) reports that Israeli exports of goods and services grew by 4.2% in the first quarter of 2005 compared with a year before, a slight deceleration from the 5.0% growth rate in the previous quarter. First-quarter growth was led by an impressive 69.8% jump in tourism receipts, which are counted as a services export. Agricultural exports also did well, increasing by 35.6% in the quarter. Factoring in the first quarter's figures, the Ministry of Finance forecasts overall 2005 export growth of 6%, following the very attractive growth rate of 14.9% in exports in 2004.

Tourism Gain Reflects Improved Palestinian-Israeli Relations

4. (U) Improved relations between Israel and the Palestinian authority, and decreasing terror attacks led tourism's star to continue to shine. (Note: Tourism is counted as a services export.) Arrivals in the first quarter of 2005 increased 25% compared with the same quarter one year before, to 372,700 from 297,700. The GOI plans to capitalize on the improvement through efforts to encourage more American Christian tourists to visit Israel. It will set up a special office in the U.S. dedicated to promoting religious tourism linked with plans to set up a bible center near the Sea of Galilee. In its efforts to cater to another group of tourists, the GOI is also investigating the option of opening a casino in the southern town of Eilat.

Imports: Disappointing First Quarter

5. (U) Imports declined by 1.4% in the first quarter of the year compared with the previous quarter. Compared to the same quarter one year before, however, first quarter 2005 imports showed growth of 11.8%. Furthermore, the import slowdown is not centered in areas linked to future economic growth: Statistics comparing the first four months of 2005 with the first four months of 2004 show that raw material imports were 13.2% higher in 2005, durable goods imports increased by 8.3%, and investment goods increased by 5.6%. Another point to note is that as the Passover holiday came at the end of April this year, imports may have been somewhat lighter in the first three months than years when Passover

falls earlier.

----- Israeli Consumption Moderates as Well... -----

16. (U) Private consumption expenditure increased by 0.8% in the first quarter of 2005, a fairly disappointing figure that represented a drop in per capita consumption. This figure was lower than in any quarter since the first quarter of 2003. The moderation may, however, be a reflection of the unusually high growth rate of the fourth quarter of 2004. To give just one example, after consumption of durable goods per capita surged 49.6% in the fourth quarter of 2004, it fell 16.5% in the first quarter. Total expenditure for private consumption declined by 1.6%, and indicates that the standard of living did not increase. As Passover came late, it could be that the second quarter will see a boost in private consumption.

17. (U) The GOI's efforts to rein in spending continues to bear fruit, evidenced by a 7.2% decrease in general government consumption the first quarter of the year. Although this did not help short-term growth, continued GOI rightsizing bodes well for the future (and conforms to USG goals outlined in the bilateral Loan Guarantee Agreement).

----- ... as Unemployment Drops Significantly -----

18. (C) According to the Finance Ministry's chief economist, Michael Sarel, figures published May 25 show unemployment fell from 9.8% - 9.1% during the first quarter. Employment grew by 33,000 positions during the period. Even more importantly, according to Sarel, the number of full-time jobs increased during the quarter, significantly outpacing a drop in part-time positions. Although this will not translate directly into increased wages and consumption, these are likely to come over time. Bufman was equally enthusiastic about the news, but noted he expects unemployment to remain at the new figure for quite some time.

----- The Deficit: GOI Says Will Remain within Budget Framework -----

19. (C) The GOI is on track to meet its 2005 deficit target, which was increased to 3.4% of GDP (NIS 18.8 billion) from 3.0% to accommodate disengagement. According to Deputy Budget Director Yossi Gordon, tax revenues are coming in at levels which will result in a deficit below the target while allowing for significant tax cuts desired by Minister Netanyahu. According to GOI numbers, the State collected NIS 52.3 billion for the first four months of 2005, compared with NIS 50.4 billion in 2004. Gordon notes the GOI is likely to finish June with a small budget surplus for the year to date, from which he draws the conclusion "There is no threat to the 3.4% deficit target in 2005." Gordon's optimism does not extend to 2006, however, as Finance still does not have a comprehensive estimate of total disengagement costs. "2006 is made even more uncertain by the fact that it will most probably be an election year," Gordon noted.

----- Privatization News: Bezek -----

110. (U) On May 9th the GOI sold 30% of the State's 46.4% holdings in Bezek to the Apax-Saban group for USD 974 million (NIS 4.3 billion). The sale was executed through a tender process in which two groups competed. The Apax-Saban group has the option of purchasing another 10.66% within four years. Following the sale, the State of Israel holds 16.4% of the shares. This marked a significant step forward in Finance Minister Netanyahu's privatization efforts, as the GOI has been trying to sell Bezek for more than 15 years. The Prime Minister said following the sale, "The fact that groups with a global reputation like the Saban and Apax groups have expressed interest in Bezek shows that the Israeli economy is winning the confidence of world markets."

----- Bank of Israel: A New Era -----

111. (U) Stanley Fischer assumed the Post of Governor of the Bank of Israel on May 1, joining the Bank at a period of historically low inflation and interest rates (currently 3.5%). The Fischer era may ring in significant change for the Bank. He has come out in favor of replacing the Bank of Israel law with a new law, which will maintain the Bank's independence while providing a sounder legal basis for the Bank's activities. He is also in favor of implementing the Bachar banking and capital market reforms and reducing Israel's large national debt burden. Initial reports

indicate that he supports the current tax plan being prepared by the Ministry of Finance. The new Governor follows in the footsteps of his predecessor on social issues, having expressed a need for a policy that will better assist the elderly, infirm, and disabled. Bufman expects Fischer to become involved in a wider range of policy issues than his predecessor, David Klein, "I expect Fischer to use his official position as economic policy advisor to the Cabinet to become involved in a wide range of issues, including the economic aspects of peace negotiations between Israel and the Palestinians." A prominent foreign banker noted that Fischer has already brought "a new professionalism" to the bank's activities.

U.S. Economy a Concern

12. (C) Both Sarel and Bufman said the course of the U.S. economy remains their biggest current concern. Bufman expressed particular concern about the possible advent of a housing bubble in the U.S. A significant downturn in the housing sector was likely seriously to impact overall U.S. growth, leading directly to a reduction in demand for Israeli exports. "I think risks coming from the U.S. economy now outweigh regional geopolitical risks," Bufman noted. Sarel echoed Bufman's concerns, noting Israel's vulnerability to economic shifts in the U.S.

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